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IN THE

Supreme Court of the United States

OCTOBER TERM, 1966.

No. 723

F. & D. RENTALS, INC.,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

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THE BURTHORP-WARREN PRINTING COMPANY, CHICAGO

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COMMISSIONER OF INTERNAL REVENUE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT.

To the Honorable Earl Warren, Chief Justice of the United States, and the Associate Justices of the Supreme Court of the United States:

OPINIONS BELOW.

The opinion of the Seventh Circuit Court of Appeals is reported in ..... F. 2d ..... and is Appendix A, *infra*, page 17.

The opinion of the Tax Court is reported in 44 T. C. 335 and is reproduced in Appendix to Brief For Petitioner, Page 139, nine copies of which Appendix were filed contemporaneously with this Petition.

JURISDICTIONAL GROUNDS.

The Seventh Circuit Court of Appeals entered its judgment on June 23, 1966. Rehearing was ordered denied, Monday, August 1, 1966; an en banc rehearing was ordered denied, Tuesday, August 16, 1966. Jurisdiction of this Court to review this judgment by writ of certiorari is conferred by 28 U. S. C. 1254(1).

QUESTIONS PRESENTED.

A vendee corporation purchases a mixed aggregate of assets for a certain cash price. The resulting allocation of the purchase price to the separate items of the asset aggregation derives from an agreement between the vendor and vendee, unrelated parties with eminently opposite interests. The vendee corporation, pursuant to this agreement, utilizes the allocation as the cost basis of the opening inventories and the cost basis for depreciable assets, in computing the federal income tax obligations due at the close of its initial allocation of the purchase price, by adopting the vendor's book values of the separate items which comprise the aggregate, without regard for the established fair market values of the respective assets and in defiance of his own Regulation § 1.167(a)-5. The Commissioner's independent allocation of the total purchase price is sustained solely by his presumption, which unsupported presumption is permitted to prevail in the face of contrary and uncontradicted evidence of fair market values of the assets adduced by the vendee taxpayer.

The questions presented are:

1. Is the Commissioner's naked presumption conclusive even in the face of contrary evidence which is uncontroverted and uncontradicted evidence adduced in the trial of a contested issue?

2. May the Commissioner arbitrarily force the vendee

to accept the vendor's book values of the purchased assets for purposes of the vendee's initial federal income tax return, in complete disregard of fair market values and contrary to the Commissioner's own regulatory enunciation?

REGULATION INVOLVED.

The regulatory provision involved in Treasury Regulation § 1.167(a)-5 (1956).

The regulation cited is set forth *infra* in Appendix B, page 34.

STATEMENT OF THE CASE.

The original South Bend Toy Manufacturing Company was an Indiana corporation, organized in 1882, engaged in the manufacture and sale of toys. Principal ownership of the original South Bend Toy resided in The National Bank of South Bend, as trustee of two separate trusts created by family members of the original business incorporators. The trusts are administered under the jurisdiction of the St. Joseph County Superior Court, a court of apposite jurisdiction located at South Bend, Indiana. In 1952, the then President and chief corporate officer of South Bend Toy resigned and departed from the State of Indiana. This departure warranted the conclusion that South Bend Toy should be sold, *i.e.*, a complete disposition of all its operational assets. During the period from 1953 to 1957, seven overtures directed to a purchase of South Bend Toy were addressed to the Bank as trustee, but none ripened into a concrete offer of purchase.

On March 15, 1957, Benjamin F. Fohrman and John W. Dorgan, both of Chicago, who had no connection with either The National Bank of South Bend or the trusts involved, offered by letter to purchase the operating assets of South Bend Toy for an amount later calculated to be $1,276,179.57.

The Bank as principal stockholder and trustee accepted the offer, subject to the administering Court's approval. The St. Joseph County Superior Court entered an order authorizing the trustee bank to vote, as majority stockholder, in favor of the sale as proposed by Messrs. Fohrman and Dorgan, on May 13, 1957.

On May 22, 1957, a formal purchase and sale agreement was entered into by South Bend Toy and Fohrman and Dorgan. The agreement, which had been approved by the Court, provided the formula by which the ultimate purchase price was to be determined and the method of allocating the purchase price among the various assets. In the event the parties failed to agree upon a proper allocation of the purchase price among the various assets, a neutral third party, Ernst & Ernst, Certified Public Accountants, was to make a decision binding on the parties. Recourse to the neutral was not, however, necessary.

The allocation of this purchase price to each category of the mixed aggregate of assets was subsequently accomplished pursuant to the agreement, reduced to writing and signed by the respective parties when the transaction was closed. The inventory value (which represented more than 60% of the total purchase price) was determined by the physical count, valuation and extension by two Certified Public Accounting firms, one representing the vendor, the other representing the vendee. The accounting firms, in conformity with recognized accounting practice, valued the inventory at the lower of cost or market.

The rights, titles and interests acquired by Fohrman and Dorgan by the purchase and sale agreement of May 22, 1957 date were assigned to the Petitioner, F & D Rentals, Inc. This assignment was effectuated on May 24, 1957.

On its tax return for the initial year of operation ending April 30, 1958, F & D Rentals utilized the allocated values

of the assets in computing its allowable depreciation deduction and the cost basis of its opening inventory. The Commissioner disagreed with the purchase price allocation made by the parties to the sale contract and chose to make his own allocation based exclusively upon an adoption of the balance sheet book values of the vendor, South Bend Toy, thereby reducing F & D's opening inventory values, and increased the values of the fixed assets, *i.e.*, land and assets affixed thereto. The Commissioner's allocation produced both an artificially disproportionate operating profit for the first tax year of F & D's existence, and a deficiency in taxes paid by F & D for this period.

F & D contested the Commissioner's deficiency determination by filing a petition with the Tax Court. The Tax Court was presented with evidence of the relative fair market values of each category of the mixed aggregate of operating assets by the Petitioner, F & D Rentals. The Commissioner did not produce any evidence of the relative fair market values of the assets purchased, but elected to rely solely upon his presumption to sustain his book value allocation and consequent tax deficiency determination. The Tax Court held that the presumption was conclusive and decided in favor of the Commissioner's book value allocation. The Seventh Circuit Court of Appeals affirmed the Tax Court 2-1; Judge Luther M. Swygert dissenting with a persuasive opinion.

The Commissioner's notice of a tax delinquency was dated September 14, 1962; the Tax Court petition was filed December 12, 1962. Jurisdiction was obtained in the Tax Court of the United States under the Internal Revenue Code of 1954, §§ 7442, 6211, 6212 and Internal Revenue Code of 1939, § 272.

REASONS FOR ISSUING THE WRIT.

This majority decision of the Seventh Circuit Court of Appeals which permits the Commissioner's presumption to enjoy the dignity of conclusive evidence is in irreconcilable conflict with applicable decisions of this Supreme Court and five other courts of appeal. Continued adherence to this misconception, clearly denies taxpayers rights to which they are entitled under the plainest of due process definitions.

This Honorable Court's decision in *Helvering* v. *Taylor*, 293 U. S. 507 (1935) stands squarely against the proposition of law espoused by the Seventh Circuit majority herein. In the *Taylor* case, *supra*, the allocation at issue involved a mixed aggregate of three classes of stock, preferred, Class A common stock, and Class B common stock acquired by the taxpayer in an approved reorganization. The taxpayer therein, made an allocation to the three classes of stock acquired and accordingly reported the gain derived from the disposition of the preferred stock the year following. The Commissioner made his own allocation of the cost basis between the preferred stock and the common stock in the manner described by the Supreme Court at page 510 of its decision:

> The Commissioner, holding the taxpayer not entitled to charge the cost of all to the preferred, apportioned between the preferred and common. He made his calculation upon the assumption that the cost, in 1927, attributable to the preferred shares bears the same relation to cost of all the shares then acquired as the amount respondent received, in 1928, for the preferred bears to the amount paid the holding company by Colonial Corporation for all the utilities shares. On that basis, he found that of the total 1927 cost, $96,030, there was chargeable to the preferred only $48,771.16, which deducted from $99,000 received by respondent for the preferred in 1928, leaves $50,228.84 upon which he determined the deficiency of $9,156.69.

The taxpayer introduced evidence concerning value to show that the Commissioner's method of allocation was arbitrary. No opposing evidence was offered by the Commissioner. The Supreme Court concurred with the taxpayer and held that the method of allocation used by the Commissioner was erroneous. In so holding, the Supreme Court made this statement at page 515-6:

> But, where as in this case the taxpayer's evidence shows the Commissioner's determination to be arbitrary and excessive it may not reasonably be held that he is bound to pay a tax that confessedly he does not owe, unless his evidence was sufficient also to establish the correct amount that lawfully might be charged against him. On the facts shown by the taxpayer in this case, the board should have held the apportionment arbitrary and the Commissioner's determination invalid. Then, upon appropriate application that further hearing be had, it should have heard evidence to show whether a fair apportionment might be made and, if so, the correct amount of the tax. The rule for which the Commissioner here contends is not consonant with the great remedial purposes of the legislation creating the Board of Tax Appeals. The Circuit Court of Appeals rightly reversed and remanded the case for further proceedings in accordance with its opinion.

This manner of summary taxpayer treatment by an overreaching Commission provoked Judge Learned Hand, author of the Second Circuit's decision in *Helvering*, v. *Taylor*, 70 F. 2d 619, which overruled the Board of Tax Appeals to observe:

> In deciding the contrary, the Board invoked the burden of proof, a rubric which has saved the Treasury many a doubtful case, but which can easily be pushed to deny taxpayers privileges plainly theirs. (at 620.)

This rubric has been similarly pushed to deny the instant Petitioner, F & D Rentals, privileges plainly theirs.

The status of a presumption in a factual contest was

discussed at length by this Court in *New York Life Ins. Co.* v. *Gamer*, 303 U. S. 161 (1938). A widow executrix sought to enforce the double indemnity provisions of a policy of insurance upon the life of her deceased husband. The character of death was the narrow issue before the trial court. The presumption against suicide reposed with the widow. The Federal District Court on trial of the cause erroneously gave a mandatory instruction elevating the presumption to the position equivalent of evidence. This Court, with the abundant citations omitted from the following abstracts, stated at 170:

> It [the Ninth Circuit Court opinion] is consistent with, if indeed it does not support, the rule that the presumption is not evidence and ceases upon the introduction of substantial proof to the contrary.

The Court emphasized at 171-2:

> The presumption is not evidence and may not be given weight as evidence. . . .

Judge Swygert's lucid dissent from the Seventh Circuit's opinion herein is in harmony with this Court's above described treatment of presumptions and draws support from both the Sixth and the Ninth Circuits:

> The Commissioner admittedly produced no evidence relating to the fair market value of the inventory items. His method was merely to spread the $300,000 reduction from book value (the purchase price) proportionally over the items listed in the inventory and fixed assets, relating the book value of each item to the total book value of all the assets. The Tax Court and the majority adopted the Commissioner's reallocation without requiring any justification for it in terms of the 'relative fair market values' rule, solely on the strength of the Commissioner's presumption of correctness. I cannot agree that the Commissioner's allocation should be so excused. Since the Commissioner's allocation is admittedly unrelated to the established

formula, it cannot be, in the words of the majority opinion, 'as reasonable as can be expected.' The arbitrary nature of his arithmetic formula is obvious. Its artificiality can hardly be doubted. In these circumstances the presumption ought not to have been used as a substitute for evidentiary proof. The Tax Court should either have made a determination on the basis of the evidence submitted or have required the Commissioner to support his allocation in accord with the applicable rule. It did neither, but relied upon a discredited presumption.

A similar problem was before the Sixth Circuit in *Bryant Heater Co. v. Commissioner,* 231 F. 2d 938 (6th Cir. 1956). There the taxpayer realized a profit of $250,000 in the sale of certain assets, which profit was necessarily attributable to either the inventory or the capital assets, or both. The taxpayer allocated the entire gain to the capital assets. The Commissioner rejected this allocation and asserted a deficiency based upon an allocation made in the same manner as in the instant case. The Commissioner simply related the book value of inventory and capital assets separately to the total book value of these groups of assets in proportioning the gain attributable to each. The Tax Court accepted the Commissioner's allocation even though no evidence relating his computations to fair market value was offered.

In reversing the decision of the Tax Court, the Court stated:

> 'The petitioners offered testimony by representatives of both the buyer and the seller showing that at the time of the sale it was understood by each of them that the inventories were being sold at approximately their book value and that a substantial premium over book value was being paid for the capital assets. The effect of this evidence in our opinion was to overcome the presumption of correctness attaching to the Commissioner's determination by demonstrating the arbitrary nature of the formula upon which it was based, invitingly convenient though that formula undoubtedly was

> . . . [However,] the petitioners' evidence was not sufficiently exact to establish their contention that no part of the gain was properly attributable to the sale of the inventories. It follows that the case should be remanded to the Tax Court for a redetermination of the amount of gain attributable to each group of assets, based upon evidence as to the fair market value of each at the time of the sale. 231 F. 2d at 939-40.'

In the recent decision of *Fulton Container Co.* v. *United States*, 355 F. 2d 319 (9th Cir. 1966), the Tax Court's adherence to a similar 'book value' allocation by the Commissioner was also rejected. There the taxpayer sold certain assets, realizing a substantial gain attributable to either fixed assets or a covenant not to compete, or both. The taxpayer allocated the entire gain to the fixed assets and reported a long term capital gain. The Commissioner, however, determined that the portion of the sales price which exceeded the book value of the fixed assets was attributable to the covenant not to compete, and made a reallocation on that basis. The Ninth Circuit reversed the Tax Court's acceptance of this reallocation and remanded the case for a redetermination, to be based upon evidence of the value of the fixed assets and the value placed upon the covenant not to compete by the parties to the sale of the assets. In the course of its discussion, the Court made the following observation:

> 'This case shows that what is euphemistically called a "presumption" becomes an absolute to sustain the Commissioner's implied finding in the deficiency determination. In practical effect it puts the imprimatur of law on the unassailable character of a figure plucked out of the air by the Commissioner. 355 F. 2d at 324, quoting from *David* v. *Phinney*, 350 F. 2d 371 (5th Cir. 1965) (dissenting opinion).'

I would remand this proceeding to the Tax Court for a redetermination in accordance with the foregoing views.

Paradoxically, the Seventh Circuit majority runs counter to its very own decision in *Wilson Athletic Goods Mfg. Company* v. *Commissioner,* 222 F. 2d 355 (1955). *Wilson* held that in instances where the Commissioner offers no evidence controverting the truth of evidence offered by the taxpayer as to value, the United States Tax Court cannot override such evidence.

The First Circuit in *Sharaf* v. *Commissioner,* 224 F. 2d 570 (1st Cir. 1955), held and pronounced a rule of law contrary to the position taken in the prevailing opinion herein.

> It is undoubtedly true that presumably the Commissioner's determination of deficiency is correct, and therefore the burden of proof in upsetting such determination rests on the taxpayer . . . However, if the record does not reveal any facts from which the Commissioner's determination could be inferred, the Tax Court is without authority to uphold such determination in the face of contrary and uncontradicted evidence (at 572).

The Fifth Circuit in *Howell Turpentine Co.* v. *Commissioner,* 162 F. 2d 319 (5th Cir. 1947) is in complete accord with the First Circuit's pronouncement in *Sharaf, supra.*

The Ninth Circuit held and pronounced a rule of law contrary to the position taken by the Seventh Circuit majority. *Niederkrome* v. *Commissioner,* 266 F. 2d 238, *cert. denied,* 359 U. S. 945 (1959).

> The decision by the Tax Court of the United States on this phase of the matter was effected by two errors of approach. First, that court held that the determination of the Commissioner was evidence to be weighed against that produced by taxpayers. This is fundamental error. We have consistently held that determination by the Commissioner raises a presumption of correctness which disappears once evidence which

would support a contrary finding has been adduced in the trial of a contested issue (at pages 240-1).

To like effect is the earlier and often quoted landmark, *San Joaquin Brick Co.* v. *Commissioner,* 130 F. 2d 220 (9th Cir. 1942). In 1943, the Ninth Circuit was again compelled to delineate the narrow limits of the Commissioner's presumption in *Hemphill Schools, Inc.* v. *Commissioner,* 137 F. 2d 961. The Commissioner's independent determination that corporate accumulations were beyond the reasonable needs of the taxpayer felt the sting of unerring law and at 964 stated:

> Evidence was produced. Some of the evidence produced by petitioner tended to prove that its gains and profits were not permitted to accumulate beyond the reasonable needs of its business. Evidence having been so produced, the presumption ceased, and thenceforth the issue depended 'wholly upon the evidence.'[9] It thus became the duty of the Board to find from the evidence, and from it alone, whether petitioner's gains and profits were permitted to accumulate beyond the reasonable needs of its business. No such finding was made. Instead, the Board treated the presumption (which no longer existed) as if it were evidence, weighed it against petitioner's evidence and concluded that petitioner's evidence did not 'overcome' it.

Fn. 9. . . . *San Joaquin Brick Co.* v. *Commissioner, supra; Helvering* v. *Talbott's Estate,* 4 Cir., 116 F. 2d 160, 162. See, also, *New York Life Ins. Co.* v. *Gamer,* 303 U. S. 161, 166-172, 58 S. Ct. 500, 82 L. Ed. 726, 114 A. L. R. 1218.

The Tenth Circuit's position is likewise in conflict, in respect of this issue, with the Seventh Circuit majority. *A. & A. Tool & Supply Co.* v. *Commissioner,* 182 F. 2d 300 (10th Cir. 1950).

> The presumption that the Commissioner's determination is correct is one of law; it is not evidence and may not be given weight as such . . . when evidence is in-

> troduced by the taxpayer sufficient for the Tax Court to base a finding contrary to the determination, the presumption disappears . . . It may not arbitrarily discredit and disregard unimpeached, competent and relevant testimony of a taxpayer which is uncontradicted (at page 304).

To like effect is the Tenth Circuit decision of *Crude Oil Corp. of America* v. *Commissioner*, 161 F. 2d 809 (10th Cir. 1947).

The Commissioner's allocation of a lump sum purchase price, based as it was on the vendor's balance sheet, is artificial, arbitrary and without foundation in either fact or law. The Seventh Circuit held in *Ketler* v. *Commissioner*, 196 F. 2d 822 (1952) that "book value" is an unreliable basis for determining true market value and so stated at page 827:

> Book value frequently bears no relationship to actual cash value or fair market value.

For the Commissioner to contend for an allocation formula bottomed upon the book value of a totally unrelated party rather than relative fair market values of the assets purchased is in marked contravention of his regulatory promulgations. The Commissioner's own regulations require that the fair market value of all assets sold shall be compared with the fair market value of each asset or category of assets sold. Regulation § 1.167(a)-5. The Commissioner manifestly and admittedly did not proceed with his determination based upon this publicly announced principle. This Court reiterated the generally recognized and accepted rule which binds the Commissioner's application of Treasury Regulations in *Helvering* v. *Winmill*, 305 U. S. 79 (1938) at 83:

> Treasury regulations and interpretations long continued without substantial change, applying to unamended or substantially re-enacted statutes are deemed to have received congressional approval and have the effect of law.

The formula adopted by the Commissioner, and approved by the lower courts herein, is totally unrelated to fair market value as required by the Treasury Regulations. The fair market value of all assets purchased has been established, viz., the total purchase price paid by the Petitioner for all assets acquired. Such assets were acquired for less than the Seller's total book value, hence the aggregate book value of the Seller cannot be said to represent fair market value of the assets sold. The Commissioner has blatently ignored this vital principle promulgated by him in his publicly announced regulations. Accordingly, the comparison of relative book values is fallacious and arbitrary upon its face in that it bears no relationship to fair market value.

As stated in the case of *Berg v. United States,* 167 F. Supp. 758 (D.C. W. D. Wis. 1958):

> Book costs or replacement costs have little or nothing to do with fair market value where there is a ready market for disposal of goods for known prices (at page 761.)

The Tax Court had most recent occasion to pass upon the question of book value as the equivalent of the mandatory fair market value of assets. *Nellie I. Brown,* T. C. Memo 1966-92 P-H Memorandum Decisions, par. 66,092 (April 28, 1966), involved the determination of fair market value of closed corporation stock for gift tax purposes. However, the basic issue was the reliability of "book value" in determining fair market value. The Commissioner presented his own witness on valuation who worked from book value in his opinion evidence as to market value. In holding that book value is an unreliable test of market value, the Tax Court stated:

> Book values of assets are frequently based on their cost and, in such case, could vary substantially from current market value. The reasoning of this witness

> [the Commissioner's witness] included several other unjustifiable assumptions favorable to the Commissioner but contrary to the evidence and the facts. He stumbled over the definition of fair market value. His reasoning and conclusions are not convincing. The respondent relies almost entirely upon the unsupported statements, reasoning and conclusion of this witness.

Thus, the United States Tax Court, in this most recent decision, repudiates the very premise which it saw fit to embrace, and which the Seventh Circuit majority supports, in the case at bar. In the case at bar, the Commissioner did not even attempt to produce any witness to show that his method of allocation (*i.e.*, the book value of seller) had any remote relationship to fair market value, but was content to rest solely upon his discredited presumption in the face of Petitioner's evidence.

To give credence to the Commissioner's unilateral allocation, so arbitrary in nature that it bears no relationship to the facts, is tantamount to this Court's telling the taxpayers of this country that resistance to the Revenue Commissioner's deficiency determination is an exercise in futility. The Tax Court will listen to evidence, but the Commissioner's presumption is an insurmountable obstacle in some geographic sections of the country.

The weight and character of all the testimony adduced at the Tax Court level should be outcome determinative of a tax claim, rather than the totally fortuitous fact of which particular Court of Appeals possesses ultimate appellate jurisdiction to review the Tax Court proceeding. The prevailing conflict between the Circuits must be resolved by this Honorable Court to assure an administration of the Revenue Statutes which comports with the basic concepts of due process. Protection of the revenue is a most laudable goal, but not worth the price in terms of the inviolate rights of the individual surrendered in the struggle.

CONCLUSION.

Petitioner prays that for the foregoing reasons a Writ of Certiorari be issued to review the judgment of the United States Court of Appeals for the Seventh Circuit entered in the above-entitled case June 23, 1966.

Respectfully submitted,

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APPENDICES.

Appendix A—Opinion of the Court of Appeals for the Seventh Circuit and Orders on Motion for Rehearing.

Appendix B—Pertinent Provisions From the Treasury Regulations.

APPENDIX A.

IN THE UNITED STATES COURT OF APPEALS
For the Seventh Circuit.

September Term, 1965—April Session, 1966.

No. 15403
F. & D. RENTALS, INC., *Petitioner,*
v.
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for Review of Decision of the Tax Court of the United States.

June 23, 1966.

Before HASTINGS, *Chief Judge,* and Swygert, *Circuit Judge* and GRANT, *District Judge.*

HASTINGS, *Chief Judge.* Petitioner, F. & D. Rentals Inc. (F & D), an Indiana corporation, appeals from an

adverse decision of the Tax Court of the United States[1] which upheld the determination by the Commissioner of Internal Revenue of a $98,540.50 deficiency in F & D's income tax for the fiscal year ended April 30, 1958.

F & D was first organized in 1957 under the name of The South Bend Toy Manufacturing, Inc., for the purpose of engaging in the manufacture and sale of toys.[2] This was the same name as that of an Indiana corporation organized in 1882 for the purpose of engaging in the manufacture and sale of toys. (Hereafter referred to as South Bend No. 1 to distinguish it from petitioner's corporation, which will be referred to as South Bend No. 2.)

South Bend No. 1 was owned principally by a South Bend bank as trustee under two separate trusts. The bank, as trustee, sought to sell South Bend No. 1, but received no firm offer prior to March 15, 1957.

On that day, Benjamin F. Fohrman and John W. Dorgan, two Chicago attorneys who had no connection with either the bank or trusts invloved, offered by letter to purchase the business.

The letter stated in part:

> "We propose to buy all assets as disclosed on balance sheet dated December 31, 1956 excepting cash, government bonds and negotiable securities for a price of $300,000.00 less than the book value of said assets * * *."

This offer was accepted, and on May 13, 1957, the principal stockholder trustee-bank filed a petition in the St. Joseph Superior Court No. 1 in St. Joseph County, Indiana,

1. *F. & D. Rentals, Inc.* v. *Commissioner of Internal Revenue*, 44 T. C. No. 32 (1965).

2. In January, 1958, its name was changed to F. & D. Rentals, Inc.

seeking approval for the sale. The petition contained, *inter alia,* the following representations:

"5. That The South Bend Toy Manufacturing Company has received a proposal from Messrs. Benjamin F. Fohrman and John W. Dorgan of Chicago, Illinois to purchase all assets of The South Bend Toy Manufacturing Company as the same shall exist on May 31, 1957, excepting and excluding from such sale cash on hand and in banks, refund claims for taxes, if any there be, federal, state and local, whether or not arising from the contemplated transaction; * * * that said prospective purchasers have offered to pay the 'book value' of the assets to be purchased as such book value is determined by the auditors of the company to be as at May 31, 1957 in accord with the normal accounting procedures employed by such company auditors in computing the book value thereof, less the sum of Three Hundred Thousand Dollars ($300,000.00), * * *

"6. That it is anticipated that such sale will result in a corporate loss of Three Hundred Thousand Dollars ($300,000.00) which, together with the seasonal net operating loss for the current fiscal year of the corporation, is likely to result in a federal net income tax refund to The South Bend Toy Manufacturing Company of approximately One Hundred Ninety-two Thousand One Hundred Dollars ($192,100.00), dependent upon variables, including the variable of the exact seasonal loss to date of closing; that, therefore, the net realization to be experienced by the corporation on account of the transaction would be approximately One Hundred Forty-four Thousand Dollars ($144,000.00) less than the book value of the net worth of the corporation as at December 31, 1956 in the amount of One Million Five Hundred Fifty-eight Thousand Six Hundred Seventy-six Dollars ($1,558,676.00) and accordingly that the net realization anticipated to the corporation from the transaction is likely to approximate One Million Four Hundred Fourteen Thousand Six Hundred Seventy-six Dollars ($1,414,676.00), subject to Indiana gross income tax and costs incident to

perfecting the transaction; that Messrs. Dorgan and Fohrman, as an incident to the transaction, have undertaken to enter a certain contract with the shareholders of the corporation whereby they will guarantee such anticipated tax refunds * * *."

On the same day, the Superior Court entered an order authorizing the trustee-bank to vote, as majority stockholder, in favor of the sale to Fohrman and Dorgan.

On May 22, 1957, a formal purchase and sale agreement was entered into by South Bend No. 1 and Fohrman and Dorgan. This agreement provided in effect that South Bend No. 1 would sell to Fohrman and Dorgan, or their nominee, all the operating assets of South Bend No. 1 at a purchase price equal to the book value of the assets, reduced by $300,000. The assets thus sold were by agreement to be listed and priced to reflect the $300,000 reduction in book value. In the event the parties failed to agree upon the proper allocation of the $300,000 among the various assets, a neutral third party was to make a decision binding on the parties.

On May 24, 1957, South Bend No. 2 was organized by Fohrman and Dorgan, and received, as their nominee, all their right, title, and interest under the agreement of purchase and sale.

Fohrman and Dorgan made the allocation of the $300,000 reduction from book value, and the trustee-bank, as majority stockholder, agreed to it.

The book value of South Bend No. 1 and the allocation of reduction were as follows:

	(1) Value per books of South Bend Toy No. 1	(2) Allocation of "reduced" purchase price by Fohrman and Dorgan	(3) Reduction if any, from book value
Current Assets			
Petty cash	$ 750.00	$ 750.00	—0—
Cash in bank	100.00	100.00	—0—
Accounts receivable	252,060.39	252,060.39	—0—
Advances for material	29,014.83	29,014.83	—0—
Prepaid insurance	15,240.38	15,240.38	—0—
Airline deposit	425.00	425.00	—0—
Total Current Assets	$ 297,590.60	$ 297,590.60	—0—
Inventory			
Raw materials	$ 353,677.93	$ 353,677.93	—0—
Work in process	111,687.77	111,687.77	—0—
Finished goods	324,986.69	324,986.69	—0—
Total Inventory	$ 790,352.39	$ 790,352.39	—0—
Deferred Charges			
Factory supplies	$ 5,003.87	$ 5,003.87	—0—
Fuel	5,607.00	5,607.00	—0—
Miscellaneous deferred charges	2,438.14	2,438.14	—0—
Total Deferred Charges	$ 13,049.01	$ 13,049.01	—0—
Fixed Assets			
Land	$ 33,645.93	$ 11,817.18	$ 21,828.75
Building (net)	152,770.01	56,524.90	96,245.11
Railway siding (net)	10,222.26	3,782.24	6,440.02
Driveway and parking lot (net)	2,686.31	993.93	1,692.38
Machinery & equipment (net)	258,403.35	95,609.24	162,794.11
Office furniture & fixtures (net)	6,940.05	2,567.82	4,372.23
Office machines (net)	6,601.31	2,442.48	4,158.83
Truck-tractor (net)	880.87	325.92	554.95
Factory trucks (net)	1,428.17	528.42	899.75
Construction in process	1,609.31	595.44	1,013.87
Total Fixed Assets	$ 475,187.57	$ 175,187.57	$300,000.00
Total Assets	$1,576,179.57	$1,276,179.57	

As is obvious from the schedule, the entire $300,000 reduction was applied to fixed assets.

After operating the business for about eight months, F. & D. entered into an agreement with Playskool Manufacturing Co., whereby a new toy company, once again named South Bend Toy Manufacturing Company, Inc., (South Bend No. 3), was formed to operate the toy business of South Bend No. 2. South Bend No. 3 was owned by F. & D. and by Playskool in equal shares. South Bend No. 3 leased No. 2's land, machinery and fixed assets.

On March 2, 1960, South Bend No. 3 purchased all the equipment, machinery, etc. of South Bend No. 2 from F. & D. for $150,000; and Playskool purchased F. & D.'s stock in South Bend No. 3 for $115,000, leasing the realty and buildings from F. & D. for a monthly rental of $3,750.

On its tax return for the year ended April 30, 1958, F. & D. computed its cost of goods sold by utilizing the amounts of South Bend No. 1's book values as the cost of its opening inventories. In computing its depreciation deduction, F. & D. utilized the amounts Fohrman and Dorgan had allocated to land and depreciable assets, an amount $300,000 less than South Bend No. 1's book values for the assets, as its cost basis for its depreciable assets.

The Commissioner determined that F. & D.'s allocation of the $300,000 reduction, as between inventory and fixed assets, was not in accord with their relative values. The Commissioner, therefore, made his own allocation, reducing the cost basis of F. & D.'s opening inventory and increasing the cost basis of land and fixed assets. The Commissioner's allocation increased F. & D.'s gross income by the amount of reduction of cost basis of opening inventory and increased F. & D.'s depreciation reduction through the increase in the cost basis of land and fixed assets.

The allocation as made by Fohrman and Dorgan and that made by the Commissioner are as follows:

	Allocation by Fohrman and Dorgan	Allocation by respondent
Current Assets		
Petty cash	$ 750.00	$ 750.00
Cash in bank	100.00	100.00
Accounts receivable	252,060.39	252,060.39
Advances for material	29,014.83	29,014.83
Prepaid insurance	15,240.38	15,240.38
Airline deposit	425.00	425.00
Total Current Assets	$297,590.60	$297,590.60
Inventory		
Raw materials	$353,677.93	$270,014.48
Work in process	111,687.77	85,014.48
Finished goods	324,986.69	248,110.24
Total Inventory	$790,352.39	$603,392.46
Deferred Charges		
Factory supplies	$ 5,003.87	$ 5,003.87
Fuel	5,607.00	5,607.00
Miscellaneous deferred charges	2,438.14	2,438.14
Total Deferred Charges	$ 13,049.01	$ 13,049.01
Fixed Assets		
Land	$ 11,817.18	$ 25,686.90
Building (net)	56,524.90	116,631.86
Railway siding (net)	3,782.24	7,804.16
Driveway and parking lot (net)	993.93	2,050.85
Machinery and equipment (net)	95,609.24	197,277.36
Office furniture and fixtures (net)	2,567.82	5,298.36
Office machines (net)	2,442.28	5,039.74
Truck-tractor (net)	325.92	672.50
Factory trucks (net)	528.42	1,090.33
Construction in process	595.44	595.44
	$175,187.57	$362,147.50

In addition to making an independent allocation of the $300,000 reduction, the Commissioner disallowed a claimed pension plan deduction of $24,500. F. & D., in acquiring South Bend No. 1, became obligated to assume the burden of two employee pension plans. On its tax return for the year ended April 30, 1958, F & D claimed a deduction of $24,500, representing an accrual on its books for contributions to pension plans. F & D made no payment to the pension plans in the tax year ended April 30, 1958, but merely incurred the obligation in that year.

F & D contested the Commissioner's deficiency determination and disallowance of deduction by filing a petition with the Tax Court. The Tax Court decided both issues in favor of the Commissioner.

On appeal, F & D argues that its allocation of the purchase price for assets was made pursuant to an arms length transaction, was realistic, and, therefore, was not subject to redetermination by the Commissioner; that the reallocation made by the Commissioner was arbitrary, that, at the very least, the purchase price should be reallocated on the basis that the fair market value each asset bears to the total fair market value of all assets; and, finally, that the pension plan liability F & D assumed should be included as a part of the total purchase price of the assets acquired.

F & D offered evidence which it claimed tended to prove the fair market value of the inventory. The evidence presented related generally to the existing backlog of firm purchase orders, the turn-over of inventory, the fact that inventory was sold in normal trade channels at normal profit margins, and the fact that the finished goods inventory was used as collateral for a loan equal to ninety per cent of its purchase value.

The Tax Court stated that such evidence did not constitute proof of the fair market value of inventory. We agree

with the Tax Court; such evidence, insofar as it bears upon the fair market value of inventory, is extremely indirect and inseparably entwines inventory value with the fact that South Bend No. 2 was a going concern.

The Tax Court found F & D's allocation artificial and unrealistic because it treated the inventory acquired as the equivalent of cash, notwithstanding the fact that finished goods represented less than half of the total book value, while raw materials and work in process made up the remaining portion. It is apparent to us that unfinished work would require additional labor and expense in finishing, and selling and shipping costs would be experienced on finished goods. This implies that the value of the existing inventory was dependent upon the fact that South Bend No. 2 was an ongoing business. Whatever its independent value, the inventory was not the equivalent of cash.

F & D presented evidence to show that the allocation of the entire $300,000 to land and fixed assets reflected the fair market value of the land and depreciable assets. The Tax Court found that the fair market values were out of line with the amount assigned the various items by Fohrman and Dorgan. The Tax Court also noted that F & D did not produce any evidence of the fair market value of the inventory.

The Commissioner is not required to accept an allocation of a lump-sum purchase price made under a contract of sale. In cases where the contract price allocation did not reflect actual values, the action of the Commissioner in making an independent allocation of his own has been upheld, or the court has looked through the agreement to discover its substance. See *Wilson Athletic G. Mfg. Co.* v. *Commissioner of Int. Rev.*, 7 Cir., 222 F. 2d 355 (1955); *Kunz* v. *C. I. R.*, 6 Cir., 333 F. 2d 556 (1964); *Copperhead Coal Company* v. *C. I. R.*, 6 Cir. 272 F. 2d 45 (1959); *Hamlin's Trust* v. *Commissioner of Internal Revenue*, 10 Cir., 209 F. 2d 761 (1954); *C. D. Johnson Lumber Corporation*, 12 T. C. 348.

We agree with the Tax Court that F & D did not present the Commissioner with a realistic allocation of the $300,000 reduction. Since we are to uphold findings of the Tax Court unless clearly erroneous, *Wilson Athletic, supra,* the finding of the Tax Court that Fohrman and Dorgan's allocation to land and depreciable assets was not in accord with fair market values will not be overturned.

It is clear that in this case, there was no evidence of the fair market values of the *inventory* F & D purchased. In the past, the Tax Court has followed the rule that allocation of a lump-sum payment among various assets should be based upon the relative values of each item to the value of the whole. *C. D. Johnson Lumber Corp., supra.* Since there was no evidence of fair market value for inventory, this rule could not be followed in the instant case, nor could the Commissioner be required to follow it.

The Commissioner evidently made his allocation by applying that percentage of the $300,000 reduction to inventory that inventory bore to the total assets, and by giving a similar treatment to fixed assets. In the absence of evidence which would indicate a proper allocation, the Commissioner's allocation is as reasonable as could be expected. It is presumptively correct, and F & D had the burden of proving that it was plainly arbitrary. *Cf. Helvering* v. *Taylor,* 293 U. S. 507 (1935); *Lucas* v. *Structural Steel Co.,* 281 U. S. 264 (1930).

As to the Commissioner's disallowance of the pension deduction, § 404(a) of the 1954 Internal Revenue Code[3]

3. This section reads in pertinent part as follows:

"Sec. 404 Deduction for Contributions of an Employer to an Employees' Trust or Annuity Plan and Compensation Under A Deferred-Payment Plan.

"(a) General Rule.—If contributions are paid by an employer to or under a stock bonus, pension, profit-sharing, or annuity plan, * * * such contributions * * * shall not be deductible under section 162 * * * or section 212 * * * but, if they satisfy the conditions of either of such sections, they

provides that pension plan contributions *paid* into a pension trust are deductible. Although F & D by agreement became obligated to make the pension payment, it was not obligated to any pension plan trustee, and, in fact, made no pension plan payment in the taxable year. We agree with the Tax Court that such an obligation cannot be considered payment under the applicable statute.

Under § 404(a) of the Code, taxpayer would have been entitled to a pension plan deduction if it had made a payment in the taxable year here in question or by the time it had filed its return. Since the Code treats pension plan contributions as a deduction, we are not persuaded by the argument that petitioner should be allowed to increase the cost basis of the assets it acquired from South Bend No. 1 by adding its unpaid pension plan obligations. Contingent obligations, insusceptible to present valuation, which are assumed as part of a purchase agreement, are not to be included in the cost basis of assets. See *Brown* v. *Helvering*, 291 U. S. 193, 200 (1934); *Albany Car Wheel Co.* v. *C. I. R.*, 333 F. 2d 653 (1964).

The decision of the Tax Court appealed from is affirmed.

AFFIRMED.

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shall be deductible under this section, subject, however, to the following limitations as to the amounts deductible in any year:

(1) Pension Trusts.—In the taxable year when paid, if the contributions are paid into a pension trust, and such taxable year ends within or with a taxable year of the trust for which the trust is exempt under section 501(a). * * *

(6) Taxpayers On Accrual Basis.—For purposes of paragraph (1) * * *, a tax-payer on the accrual basis shall be deemed to have made a payment on the last day of the year of accrual if the payment is on account of such taxable year and is made not later than the time prescribed by law for filing the return for such taxable year (including extensions thereof).

No. 15403.

SWYGERT, *Circuit Judge,* dissenting in part.

Both the Tax Court and the majority recognize the Tax Court's own rule that when a taxpayer buys a mixed aggregate of assets for a lump sum, the allocation of the purchase price to the separate items should be based upon the relative value of each item to the value of the whole. This rule requires that the fair market value of each item be established and then that the proportion which the fair market value of each item bears to the total fair market value of the aggregate be applied to the lump-sum purchase price, in order to determine the portion of the purchase price to be allocated to each item. The Tax Court and the majority, having recognized the rule, conclude that the petitioner failed to introduce any evidence of the fair market value of the inventory purchased and that therefore the rule cannot be applied in this case. The majority adds "nor could the Commissioner be required to follow it." I do not agree with either of these conclusions.

In the Tax Court proceeding, the petitioner submitted the following evidence bearing upon the fair market value of the inventory: (1) the inventory was purchased only after a physical audit conducted by independent auditors which priced the inventory items at the lower of cost or market value; (2) at the date of purchase there was a backlog of orders totaling $523,500; (3) inventory turnover was two to four times per year; (4) the inventory was sold in normal trade channels at a normal profit;[1] and (5) the finished goods included in the inventory

1. In eight months of active operation the sales of the petitioner amounted to $2,070,580. The gross profit realized was $500,560, a gross profit margin of 24.17 per cent. This margin is closely comparable to the profit margin experienced by South Bend Toy No. 1 for the years 1952 through 1956. The effect of the Commissioner's allocation is to exaggerate the gross profit margin on sales made by the petitioner from the normal level to 33.20 per cent.

were used as collateral for a loan equal to ninety per cent of their book value. "Certainly the first of these items alone is some evidence of fair market value, and in any event the evidence introduced shows that the value of the inventory was greater than that assigned by the Commissioner."

The Commissioner admittedly produced no evidence relating to the fair market value of the inventory items. His method was merely to spread the $300,000 reduction from book value (the purchase price) proportionally over the items listed in the inventory and fixed assets, relating the book value of each item to the total book value of all the assets. The Tax Court and the majority adopted the Commissioner's reallocation without requiring any justification for it in terms of the "relative fair market values" rule, solely on the strength of the Commissioner's presumption of correctness. I cannot agree that the Commissioner's allocation should be so excused. Since the Commissioner's allocation is admittedly unrelated to the established formula, it cannot be, in the words of the majority opinion, "as reasonable as can be expected." The arbitrary nature of his arithmetic formula is obvious. Its artificiality can hardly be doubted. In these circumstances the presumption ought not to have been used as a substitute for evidentiary proof. The Tax Court should either have made a determination on the basis of the evidence submitted or have required the Commissioner to support his allocation in accord with the applicable rule. It did neither, but relied upon a discredited presumption.

A similar problem was before the Sixth Circuit in *Bryant Heater Co.* v. *Commissioner,* 231 F. 2d 938 (6th Cir. 1956). There the taxpayer realized a profit of $250,000 in the sale of certain assets, which profit was necessarily attributable to either the inventory or the

capital assets, or both. The taxpayer allocated the entire gain to the capital assets. The Commissioner rejected this allocation and asserted a deficiency based upon an allocation made in the same manner as in the instant case. The Commissioner simply related the book value of inventory and capital assets separately to the total book value of these two groups of assets in proportioning the gain attributable to each. The Tax Court accepted the Commissioner's allocation even though no evidence relating his computations to fair market value was offered.

In reversing the decision of the Tax Court, the court stated:

> The petitioners offered testimony by representatives of both the buyer and the seller showing that at the time of the sale it was understood by each of them that the inventories were being sold at approximately their book value and that a substantial premium over book value was being paid for the capital assets. The effect of this evidence in our opinion was to overcome the presumption of correctness attaching to the Commissioner's determination by demonstrating the arbitrary nature of the formula upon which it was based, invitingly convenient though that formula undoubtedly was . . . [However,] the petitioners' evidence was not sufficiently exact to establish their contention that no part of the gain was properly attributable to the sale of the inventories. It follows that the case should be remanded to the Tax Court for a redetermination of the amount of gain attributable to each group of assets, based upon evidence as to the fair market value of each at the time of the sale. 231 F. 2d at 939-40.

In the recent decision of *Fulton Container Co.* v. *United States,* 355 F. 2d 319 (9th Cir. 1966), the Tax Court's adherence to a similar "book value" allocation by the Commissioner was also rejected. There the taxpayer sold certain assets, realizing a substantial gain

attributable to either fixed assets or a covenant not to compete, or both. The taxpayer allocated the entire gain to the fixed assets and reported a long term capital gain. The Commissioner, however, determined that the portion of the sales price which exceeded the book value of the fixed assets was attributable to the covenant not to compete, and made a reallocation on that basis. The Ninth Circuit reversed the Tax Court's acceptance of this reallocation and remanded the case for a redetermination, to be based upon evidence of the value of the fixed assets and the value placed upon the covenant not to compete by the parties to the sale of the assets. In the course of its discussion, the court made the following observation:

> This case shows that what is euphemistically called a "presumption" becomes an absolute to sustain the Commissioner's implied finding in the deficiency determination. In practical effect it puts the imprimatur of law on the unassailable character of a figure plucked out of the air by the Commissioner. 355 F. 2d at 324, quoting from *David* v. *Phinney*, 350 F. 2d 371 (5th Cir. 1965) (dissenting opinion).

I would remand this proceeding to the Tax Court for a redetermination in accordance with the foregoing views.

I concur in that portion of Judge Hastings' opinion relating to the Commissioner's disallowance of the claimed deduction for accrued contributions to the pension plans.

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

Monday, August 1, 1966

Before

Hon. John S. Hastings, Chief Judge,
Hon. Luther M. Swygert, Circuit Judge,
Hon. Robert A. Grant, District Judge.

F. & D. RENTALS, INC., *Petitioner,*
No. 15403 *vs.*
COMMISSIONER OF INTERNAL REVENUE, *Respondent.*

Petition for review of a decision of the Tax Court of the United States.

IT IS ORDERED that the petition for rehearing of this cause filed herein by petitioner, F. & D. Rentals, Inc., be, and the same is hereby DENIED.

(Judge Swygert voted to grant the petition.)

UNITED STATES COURT OF APPEALS

For the Seventh Circuit

Chicago, Illinois 60604

Tuesday, August 16, 1966

Before

Hon. John S. Hastings, Chief Judge,
Hon. Elmer J. Schnackenberg, Circuit Judge,
Hon. Win G. Knoch, Circuit Judge,
Hon. Latham Castle, Circuit Judge,
Hon. Roger J. Kiley, Circuit Judge,
Hon. Luther M. Swygert, Circuit Judge.

F. & D. RENTALS, INC., *Petitioner,* vs. COMMISSIONER OF INTERNAL REVENUE, *Respondent.*	Petition for review of a decision of the Tax Court of the United States.

No. 15403

IT IS ORDERED by the Court that the petition of F. & D. Rentals, Inc. for a rehearing of this cause *en banc* be, and the same is hereby DENIED.

(Swygert, *C. J.* voted to grant the petition. Cummings, *C. J.* did not participate in the consideration of this matter.)

APPENDIX B.

§ 1.167(a)-5.

Apportionment of Basis.

In the case of the acquisition on or after March 1, 1913, of a combination of depreciable and nondepreciable property for a lump sum, as for example, buildings and land, the basis for depreciation cannot exceed an amount which bears the same proportion to the lump sum as the value of the depreciable property at the time of acquisition bears to the value of the entire property at that time. In the case of property which is subject to both the allowance for depreciation and amortization, depreciation is allowable only with respect to the portion of the depreciable property which is not subject to the allowance for amortization and may be taken concurrently with the allowance for amortization. After the close of the amortization period or after amortization deductions have been discontinued with respect to any such property, the unrecovered cost or other basis of the depreciable portion of such property will be subject to depreciation. For adjustments to basis, see section 1016 and other applicable provisions of law. [Reg. § 1.167(a)-5.] [T. D. 6182, 6-11-56.]

In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 723

F. & D. RENTALS, INC., PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioner purchased the operating assets of the South Bend Toy Manufacturing Co. for $300,000 less than their book value as shown on the seller's books. The purchase agreement provided that if the parties were unable to agree on the proper allocation among the assets of the $300,000 reduction in book value, the question would be submitted to a neutral arbitrator. The final contract allocated the entire $300,000 reduction in book value to fixed assets, with no part of the reduction being applied to inventory. The individual representing the seller testified that the seller had no financial interest in this allocation. On its 1958 tax return petitioner (1) used the seller's book values as

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the cost of its opening inventories in computing its cost of goods sold and (2) used the seller's book values less $300,000 as the cost basis of its land and depreciable assets in computing depreciation.

The Commissioner determined that petitioner had not correctly allocated the purchase price to the assets purchased in accordance with their relative values. Accordingly, he made his own allocation which resulted in a reduction of the cost basis of petitioner's opening inventory and an increase in the cost basis of its fixed assets. This change in the allocation resulted in a tax deficiency, since it reduced petitioner's cost of goods sold by a greater amount than it increased its depreciation. (R. 140–157.)[1] The Tax Court sustained the Commissioner (R. 139–160), and the court of appeals affirmed (Pet. 17–27).

Both lower courts agreed (1) that a lump sum purchase price should be allocated among the assets purchased in proportion to the relative values of each item purchased,[2] and (2) that the Commissioner is not required to accept an allocation specified in a contract of sale where that allocation is unrealistic and does not reflect the assets' actual values.[3] (Pet. 25–26; R. 153–

[1] "R." references are to the appendix to petitioner's brief in the court of appeals.

[2] See, *e.g.*, *Kunz* v. *Commissioner*, 333 F. 2d 556 (C.A. 6), affirming *per curiam* the decision of November 21, 1962. (P-H Memo T.C., par. 62, 276); *Copperhead Coal Co.* v. *Commissioner*, 272 F. 2d 45 (C.A. 6); *Hamlin's Trust* v. *Commissioner*, 209 F. 2d 761 (C.A. 10).

[3] See, *e.g.*, *Kunz* v. *Commissioner*, *supra*; *Copperhead Coal Co.* v. *Commissioner*, *supra*; *Majestic Securities Corp.* v. *Commissioner*, 120 F. 2d 12 (C.A. 8).

154.) Petitioner does not contest these two well-established propositions of law but argues only that the Tax Court failed to give proper regard to its evidence of the assets' fair market value. Thus, the instant case involves primarily a factual question which both lower courts decided in favor of the Commissioner.

The decision below is correct. Petitioner failed to prove the fair market value of the purchased inventory. As the court of appeals stated (Pet. 26):

> It is clear that in this case, there was no evidence of the fair market values of the *inventory* F & D purchased. In the past, the Tax Court has followed the rule that allocation of a lump-sum payment among various assets should be based upon the relative values of each item to the value of the whole. *C. D. Johnson Lumber Corp., supra* [12 T.C. 348]. Since there was no evidence of fair market value for inventory, this rule could not be followed in the instant case, nor could the Commissioner be required to follow it.
>
> The Commissioner evidently made his allocation by applying that percentage of the $300,000 reduction to inventory that inventory bore to the total assets, and by giving a similar treatment to fixed assets. In the absence of evidence which would indicate a proper allocation, the Commissioner's allocation is as reasonable as could be expected. It is presumptively correct, and F & D had the burden of proving that it was plainly arbitrary. *Cf. Helvering* v. *Taylor,* 293 U.S. 507 (1935); *Lucas* v. *Structural Steel Co.*, 281 U.S. 264 (1930).

Petitioner's evidence on this point related generally to the existing backlog of purchase orders, the turn-over of inventory, the fact that inventory was sold in normal trade channels at normal profit margins, and the fact that the finished goods inventory was used as collateral for a loan equal to 90 percent of its book value. As both lower courts concluded, these facts did not prove the fair market value of the inventory (Pet. 26; R. 154–155). Moreover, the land and buildings could not possibly have had the minimal fair market value arbitrarily allocated to them by petitioner (R. 149, 152). Finally, the record shows that the allocation specified in the contract of sale was petitioner's unilateral determination. As the Tax Court pointed out (R. 153), the seller was concerned only with the overall price paid for the business, and not with the allocation between items. Where, as here, the taxpayer fails to prove that the contract allocation is a realistic reflection of the assets' actual values, the Commissioner need not accept it.

Furthermore, the taxpayer failed to demonstrate that the allocation made by the Commissioner was erroneous. The taxpayer has a "heavy burden of proving that the Commissioner's action was plainly arbitrary." *Lucas* v. *Structural Steel Co.*, 281 U.S. 264, 271; *Helvering* v. *Taylor*, 293 U.S. 507, 515; *Welch* v. *Helvering*, 290 U.S. 111, 115; *Brunet* v. *Houston*, 283 U.S. 223, 227–228. Here, petitioner failed to meet this burden. As the Tax Court stated (R. 157):

> We accordingly approve the Commissioner's allocation in the absence of competent evidence that it is erroneous.

The cases cited by petitioner are inapposite. Cases holding that the Commissioner's determination is not to be considered as evidence (Pet. 11–13) have no application here, for the courts below did not so treat the Commissioner's determination. Similarly, those cases where the taxpayer had introduced sufficient evidence to satisfy his burden of proof (Pet. 6–13) are not relevant to the instant case since petitioner failed to satisfy its burden. For example, in *Bryant Heater Co.* v. *Commissioner*, 231 F. 2d 938 (C.A. 6), which involved the allocation of purchase price between inventory and capital assets, the taxpayer had demonstrated in support of its allocation that both buyer and seller understood that inventories were being sold at approximately book value and that a substantial premium was being paid for the capital assets. In contrast, the petitioner in this case unilaterally allocated the $300,000 to inventory and failed to carry its burden of either proving a proper allocation on the basis of fair market value or demonstrating error in the Commissioner's allocation.

The cases cited on the unreliability of book value in determining fair market value (Pet. 13–15) are likewise not in point. The contract under which petitioner purchased the assets specifically stated that petitioner was paying "a price of $300,000.00 less than the book value of said assets" (R. 142). Thus the sole question in this case is how to apportion the $300,000 reduction in book value among the assets. Since petitioner failed to prove the assets' fair market values, or that the Commissioner's allocation was not

"as reasonable as could be expected," the lower courts, in light of the unusual contract in question, accepted the Commissioner's apportionment among the assets in proportion to their book value.

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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DECEMBER 1966.

U.S. GOVERNMENT PRINTING OFFICE: 1966